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Edison Explains

Collateralised loan obligations (CLOs)

What are CLOs and why have they performed well over the last year?

What is the market outlook for CLOs?

Last year, the collateralised loan obligation (CLO) market remained broadly favourable. This was especially true in the US, where investors are looking for floating rate debt investments that are resilient against the interest hikes the Fed seems set on continuing.

At the same time, changes to the retention rules in the US have reduced CLO capital requirements for managers, to their benefit. This increases the supply of new CLOs as managers look to take advantage of the new rules. In October, Wells Fargo predicted $130bn of new US CLO issues for 2018, cutting its forecast by $20bn, from earlier that year, but breaking the $124bn post-crisis record set in 2014.

The European CLO market also did well, seeing its highest level of activity since the financial crisis, with 2018 issue volume up 40% compared to 2017, according to S&P Global Ratings.

What are collateralised loan obligations?

Collateralised loan obligations were created by banks in the early 1990s to package loans together into an investment vehicle that contains varying degrees of risk and return.

Through the 1990s, then again following the financial crash, CLOs were further refined. A modern CLO relies on leveraged, high-yield (and mostly senior secured) loans, which it collates into a portfolio.

A CLO usually generates returns through repayments on its portfolio of loans throughout its lifetime and at its final maturity. At maturity, the CLO is unwound, all loans are redeemed or auctioned off, and those with an equity stake in the company receive their rewards. In the interim, CLOs sell interest-paying notes in a series of tranches to fund the purchase of additional loans for its portfolio.

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"A CLO is a structured instrument that collates loans into a portfolio and finances it by issuing notes (tranches). Income from the portfolio is distributed to noteholders according to a 'waterfall' structure, with increasing yield and risk, the lower the seniority. The last tranche has no fixed coupon and receives the residual cash flow." Michael Mordel, analyst

How are investors rewarded?

CLOs sell interest-paying notes in a system of tranches.

The tranches are rated by their level of security, with AAA note holders being paid out first from the returns. These 'senior tranches' receive slim rewards in recompense for the security afforded their high status in the repayment hierarchy.

Mezzanine tranches, rated below AAA and above BB, are riskier due to their status in the repayment scheme, but receive higher yields as a result.

Below the mezzanine tranches are junior notes, rated BB or B, with all the associated risks and rewards of notes that sit further down the repayment ladder.

The final tranche comprises equity investors, who receive the residual payment after more senior tranches. They take a large proportion of the risk and are rewarded with powerful incentives in favourable market conditions.

What risks do CLO equity investors carry?

Those who invest in a CLO's equity tranche receive only what is left of the CLO's cash flow, after all other tranches are paid and management fees accounted for. This 'waterfall' structure is used for coupon payments, as well as final payment at maturity. Additionally, tests are performed that can redirect residual cash flow to early repayments of senior tranches.

As a result, equity investors accrue heavy losses if a CLO fails to meet expectations, but are rewarded with attractive returns if it does well. CLO returns on equity tend to hover around c 15%, but can sometimes be as high as 30% on an annualised basis.

Most modern CLOs require one notable 'control investor', who buys and holds the majority of the CLO's equity.

Who invests in CLOs?

In addition to the control investor, CLO equity is traded widely. Retail investors, pension funds, hedge funds and publicly listed investment funds all trade CLO equity. The CLO manager often holds some equity as well.

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In terms of CLO tranches, historically, banks have been the largest investors in the triple-A segment. However, demand from banks for senior tranches has declined following the financial crisis, partly due to regulation. Some of this slack has been taken up by US pension funds and insurance companies.

Similarly, mutual funds were highly active in triple-B and double-B rated tranches, that is until the financial crash. Since then, funds and insurance companies are more partial to A and double-A notes than they once were.

As for mezzanine and junior tranches, specialist funds, like hedge funds, are the largest market.

What distinctions are made between CLOs?

Most CLOs are arbitrage CLOs, which make their profits from the spread between interest and loan repayments and expenses. That said, CLOs are highly varied, with new generations adding features, like triple-C tranches, or special discount purchase rules. However, there are some clear distinctions to be made.

The most common distinction is between CLOs established before the financial crash (CLO 1.0) and after (CLO 2.0). CLOs launched after the crash reflect a more cautious approach and tend to share certain features, including a shorter reinvestment period and lower levels of leverage. Moreover, the introduction of risk retention rules has reduced the originate-to-distribute risks.

Distinctions are also made for CLOs that trade in mid-market loans, originated from small companies traditionally earning less than $50m, and 'broadly syndicated loans', which are originated by larger companies.

Finally, CLOs can be either actively managed or static. In the latter case, the underlying pool of loans is not changed until maturity. However, most CLOs are actively managed.

What types of CLO fund exist?

There are a variety of funds that invest in CLO vehicles. Among them, some funds invest only in the mezzanine tranche, like the recently launched Neuberger Berman UCITS for CLOs. Others, like the Barings Investment Grade CLO Fund, aim to retain a portfolio in tranches rated A or above.

On the other hand, Volta Finance, whose CLO investments make up 75% of its portfolio, actively shifts between equity and debt tranches depending on the market outlook.

There are also funds that invest primarily in the equity tranche, for instance Carador Income Fund and the Fair Oaks Income Fund.

The market has also pumped out risk retention vehicles. They invest primarily in CLO equity, eg Blackstone/GSO Loan Financing (BGLF) and Marble Point Loan Financing. After the recent repeal of risk retention rules in the US, these vehicles may become less popular.